Internal Revenue Service

memorandum

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TS/JLRICKS

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to: District Counsel, Los Angeles W:LA
Attn: Fera Wagner, ISP Industry Counsel,
Savings and Loan Associations

from: Assistant Chief Counsel (Tax Litigation) CC:TL
Attn: Jo Lynn Ricks, ISP Coordinator,
~~Savings and Loan Associations~~

subject: [redacted] - I.R.C. § 461(e) Issue

This memorandum is in response to your request of November 10, 1988, for technical advice concerning whether we should pursue the following legal issues at trial.

ISSUES

1. Whether section 461(e) precludes [redacted] from deducting, in full, [redacted] months of interest, which was credited to the depositors' accounts on [redacted], in [redacted]'s short period return filed for [redacted] to [redacted]?

2. Assuming that section 461(e) precludes [redacted] from deducting such credited interest in full, in which period should the disallowed interest be deducted?

3. Whether the portions of Treas. Reg. § 1.461(e) which apply section 461(e) principles to short period taxable years are valid?

CONCLUSIONS

1. Section 461(e) and Treas. Reg. § 1.461-1(e)(1)(i) preclude [redacted] from deducting, in full, [redacted] months of interest in the short period taxable year.

2. Since section 461(e) precludes [redacted] from deducting such credited interest in full, [redacted] was required to apportion the disallowed amounts in accordance with Treas. Reg. § 1.461-1(e)(2) and (3).

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3. The portions of Treas. Reg. § 1.461(e) which apply section 461(e) principles to short period taxable years are valid.

FACTS

[redacted] purchased the assets and liabilities of [redacted], a California corporation ("[redacted]"). The assets of [redacted] included all of the stock of its wholly owned savings and loan subsidiary, [redacted]. [redacted] subsequently merged into [redacted], and [redacted] adopted [redacted]'s name. ([redacted], as merged into [redacted], will hereinafter be referred to as "[redacted]").

On [redacted], [redacted] was acquired by [redacted], a Delaware corporation. The [redacted] purchased the stock of [redacted] from [redacted], the holding company of [redacted]. [redacted] did not elect to treat the stock purchase as an asset acquisition under section 338 and did not liquidate [redacted]. 1/

The acquisition of [redacted] by [redacted] created a short period taxable year from [redacted] through [redacted]. In the short period return, [redacted] claimed an interest expense of $[redacted]. This deduction consisted of between [redacted] to [redacted] months of interest, which was credited to the depositors' accounts on [redacted]. We assume that the amounts which [redacted] credited as interest on [redacted] were withdrawable by the holder of such accounts on [redacted], subject only to customary notice of the holders' intention to withdraw the interest. *See* I.R.C. §§ 461(e) and 591(a). This interest expense created a substantial net operating loss.

1/ The Appeals officer believes that, at the time of the acquisition, the acquisition qualified as one to which section 381(a)(1) applied. Section 381(a)(1), as in effect for acquisitions occurring after August 31, 1982, states that section 381(a) treatment should be afforded "[i]n the case of the acquisition of assets of a corporation by another corporation - (1) in a distribution to such other corporation to which section 332 (relating to the liquidation of subsidiaries) applies." However, the acquisition of [redacted] by [redacted] does not fall within the literal language of § 381(a)(1) for two reasons: (1) [redacted] acquired the assets of [redacted] through a stock transaction, and not an asset transaction; and (2) such acquisition did not occur in a distribution to [redacted] to which section 332 applies.

On [redacted], [redacted] filed a Form 1139, Corporation Application for Tentative Refund, which carried back the net operating loss deductions to the tax returns of [redacted] and its savings and loan subsidiary. The Service allowed such carrybacks and made tentative refunds.

We note that around [redacted], the FHLBB determined that [redacted] was insolvent and placed it in receivership. The FSLIC created a new entity, [redacted], a Federal Savings and Loan Association ([redacted]), and transferred some of the assets from [redacted] to [redacted].

DISCUSSION

A. Background

Section 591 provides that savings and loans are allowed to deduct from gross income "amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts, if such amounts paid or accrued are withdrawable on demand subject only to customary notice of intention to withdraw." When discussing the taxable year in which the deductions provided in section 591 are applicable, Treas. Reg. § 1.591-1(b)(2) refers to the special rules under section 461(e).

Section 461(e) limits the amount of the deductions under section 591 for dividends and interest credited to a depositor's account. Section 461(e) provides that, except as provided by regulations prescribed by the Secretary, a savings and loan cannot deduct amounts it has paid or credited to depositors' accounts as interest or dividends on their withdrawable accounts "to the extent such amounts are paid or credited for periods representing more than 12 months." However, the savings and loan will be able to deduct the amounts disallowed in another taxable year "as the Secretary determines to be consistent with the preceding sentence." I.R.C. § 461(e).

The legislative history accompanying section 461(e) provides that:

> It is contemplated that in any cases involving a short year, the Secretary will use his regulatory authority already available to prevent the deduction in such years for periods in excess of the appropriate number of months, or portions of months.

H. Rep. No. 2544, 87th Cong., 2d Sess. 3-4 (1962). Accordingly, Treas. Reg. § 1.461-1(e)(1)(i) provides that for a short period taxable year, the savings and loan will be denied a deduction for dividends or interest paid or credited:

> to the extent that such amounts are paid or credited for a period representing more than the number of months in such short period. In such a case, the rules contained in section 461(e) and this paragraph apply to the short period in a manner consistent with the application of such rules to a 12-month taxable year.

Treas. Reg. § 1.461-1(e)(1)(i) defines a short period as "a taxable year consisting of a period of less than 12 months."

The Treasury Regulations provide two exceptions to the foregoing nonallowance rules. Treas. Reg. § 1.461-1(e)(1)(ii). First, the foregoing rules are inapplicable to the taxpayer in the year in which it liquidates. However, if the liquidation is a part of, or follows an acquisition of the taxpayer's assets, and the acquiring corporation takes into account certain items of the target corporation pursuant to section 381(a), the foregoing nonallowance rules will still apply. Treas. Reg. § 1.461-1(e)(1)(ii). Second, the nonallowance rules provided in section 461(e) and Treas. Reg. § 1.461-1(e)(1)(i) are inapplicable to taxpayers who pay or credit grace interest or dividends to depositors or shareholders who terminate their account, as long as the total amount of the grace interest or dividends paid or credited during the period is equal to or less than 10% of the total interest or dividends generally paid or credited during such period.

After deciding whether the savings and loan will be denied a portion of its interest or dividend deduction under Treas. Reg. § 1.461-1(e)(1)(i), the Treasury Regulations then provide a method for calculating the amount of interest which is to be disallowed. The amount of interest which is disallowed is calculated by taking the difference between:

> the total amount of dividends or interest paid or credited to that class of accounts with respect to which a deduction is not allowed under subparagraph (1) of this paragraph during the taxable year (<u>or short period, if applicable</u>) and an amount which bears the same ratio to such total as the number 12 (or number of months in the short period) bears to the number of months with respect to which such amounts of dividends or interest are paid or credited.

Treas. Reg. § 1.461-1(e)(2) (emphasis added). Treas. Reg. § 1.461-1(e)(3) provides two instances in which the savings and loan will be able to deduct the disallowed interest in later taxable years. First, such disallowed interest can be deducted in any later taxable year as long as the deduction, when combined with the interest or dividend deductions allowable in the later taxable year, do not represent a period of more than 12 months or a period greater than the number of months in the short period.

Second, even if such deductions represent (1) a period of more than 12 months or (2) a period greater than the number of months in the short period, the taxpayer can deduct one-tenth of the disallowed amount as a deduction in the 10 succeeding taxable years if the Commissioner is satisfied that the taxpayer did not intend to avoid taxes. Treas. Reg. § 1.461-1(e)(3)(ii). If the disallowed amount is for a tax year ending after July 1, 1964, the savings and loan can begin to deduct 10% of the disallowed amount in the taxable year that the deduction was disallowed. Treas. Reg. § 1.461-1(e)(3)(ii). If the deduction is denied solely because the taxpayer was a party to an acquisition described in section 381(a), the Commissioner will allow the taxpayer to take the denied interest deductions over a 10 year period in accordance with the foregoing rule. Id.

If the savings and loan liquidates or ceases to do business before it has taken a deduction for all of the interest deductions it is entitled to, it can deduct the balance of the interest deductions not previously taken in the taxable year it liquidates or otherwise ceases to do business. Treas. Reg. § 1.461-1(e)(3)(iii). However, if the savings and loan is the target of an acquisition described in section 381(a), the acquiring corporation will succeed to the balance of the disallowed interest expense. The acquiring corporation will account for such amounts on the same basis as the target, had the target remained in existence. Treas. Reg. § 1.461-1(e)(3)(iii).

B. <u>Respondent properly disallowed a portion of petitioner's claimed interest expense under Treas. Reg. § 1.461-1(e)</u>.

1. <u>Since [redacted] failed to comply with Treas. Reg. § 1.461-1(e), [redacted] cannot claim the full amount of the interest deduction it reported on its short period tax return</u>.

Petitioners failed to comply with the Treasury Regulations under § 1.461-1(e). Petitioner deducted as an interest expense interest which was credited for a period representing [redacted] months, which exceeded the [redacted] day period represented by [redacted]s short period taxable year. None of the exceptions to the disallowance rules apply to [redacted]. [redacted] was not liquidated after it was acquired by [redacted]. Further, based on our subsequent telephone conversation, we assume that the exception to section 461(e) for taxpayers who pay or credit grace interest or dividends to terminating depositors does not apply to [redacted]. Accordingly, the respondent properly disallowed as a deduction for the short period taxable year the proportionate amount of accrued interest credited for the periods representing more than [redacted] days.

2. Since Treas. Reg. § 1.461-1(e) is applicable to [redacted]. [redacted] was required to apportion the disallowed amounts in accordance with Treas. Reg. § 1.461-1(e)(2) and (3).

Moreover, the computation set forth on page 6 of the Appeals Supporting Statement for [redacted]'s short period 2/ correctly reflects the amount of the interest disallowed under Treas. Reg. § 1.461-1(e)(2). The acquisition of [redacted] resulted in an interest expense of $[redacted], representing a period of [redacted] days (the number of days in the [redacted] month period of [redacted] through [redacted]). Pursuant to Treas. Reg. § 1.461-1(e)(2), Appeals calculated that the amount which should be disallowed as a deduction in the short period is the amount which is in excess of $[redacted] (which equals $[redacted] multiplied by the ratio of number of days in the short period ([redacted]) over the number of days with respect to which the interest was credited ([redacted]). Accordingly, Appeals calculated the unallowable interest credited in the short period to be $[redacted] ($[redacted] - $[redacted].

Furthermore, under Treas. Reg. § 1.461-1(e)(3)(ii), Appeals took the position that [redacted] of the disallowed interest, or $[redacted], should be deducted in the [redacted] subsequent taxable years, beginning with the [redacted] short period. Accordingly, the Appeals Supporting Statement correctly stated that a portion of [redacted]'s claimed interest expense should be disallowed pursuant to section 461(e) and Treas. Reg. § 1.461-1(e) and correctly stated petitioners' adjusted tax liability.

3. Petitioners' Contentions

Petitioners have raised the following two arguments to Appeals. First, petitioners argued that since Treas. Reg. § 1.461-1(e)(1)(i) and (e)(2) refer to the number of "months" in the short period, these Treasury Regulations are inapplicable to [redacted] since the short period was [redacted] days. Although Treas. Reg. § 1.461-1(e)(1)(i) describes the amount of interest disallowed for a short period as the amounts paid or credited for a period exceeding the number of "months" in such short period, this phrase does not render the Treasury Regulation inapplicable to short periods which are less than a month. Such a literal interpretation of this regulation would be at odds with the other

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2/ All of the calculations referred to in this memorandum were done by Appeals and are contained in the Appeals Supporting Statement.

wording of the Treasury Regulation as well as the Congressional intent underlying section 461(e).

Treas. Reg. § 1.461-1(e)(1)(i) specifically defines a short period as "a taxable year consisting of a period less than 12 months." Accordingly, the regulation implicitly recognizes that a short taxable year may be a portion of a month. In addition, the legislative history explicitly states Congress' intent to apply the disallowance provisions of section 461(e) to short periods consisting of a few days. Congress intended that the Secretary promulgate regulations to prevent a savings and loan from taking a deduction representing periods "in excess of the . . . portions of months" in the short period taxable year. H. Rep. No. 2544, 87th Cong., 2d Sess. 4 (1962).

Similarly, Treas. Reg. § 1.461-1(e)(2) discusses the computation of the interest or dividend expenses disallowed as a deduction during a short period on the basis of the number of "months" in the short period. However, this language cannot be construed to mean that the computation cannot be done in a short period taxable year which is less than one month. Since Congress intended that interest or dividend deductions be disallowed for periods in excess of portions of months, we can infer that Congress would have intended the calculation to apply when there is a short period consisting of a few days. Accordingly, it was proper for the Service to determine the amount of disallowed interest on a daily basis and apply the same principles set forth in Treas. Reg. § 1.461-1(e)(2).

Indeed, the Service has determined in other circumstances that the monthly computation provided in Treas. Reg. § 1.461-1(e)(2) should be made on a daily basis. PLR7825013. In PLR7825013, a savings and loan changed its method of paying interest on its savings certificates. Prior to October 1, 1986, the savings and loan paid interest on its savings certificates three months after their issuance and each succeeding three months thereafter. During the taxable year ended September 30, 1977, the savings and loan decided to change its date of paying interest on the savings certificates to the last date of each calendar year quarter. Accordingly, during the first quarter ending December 31, 1976, interest was paid as usual. The savings and loan also paid interest on all certificates from the date of the last payment through December 31, 1976. After that date, the savings and loan paid interest according to its new method, i.e., on the last date of each calendar quarter.

The Service ruled that the savings and loan should determine, on a certificate by certificate basis, "the total amount of interest paid on each certificate during the taxable year and the appropriate number of days for which this interest was paid."

PLR7825013, supra, at 2. For those certificates for which interest was paid for more than 365 days, the amount which was disallowed as a deduction equals the difference between:

> the total amount of interest paid and an amount which bears the same ratio to such total as the number 365 bears to the number of days with respect to which such amounts are paid or credited.

Id. (Emphasis added).

Petitioners also argued to Appeals that if there were no acquisition, the interest deductions [redacted] took for [redacted] would be attributable to a 12 month period and, thus, section 461(e) would not apply. Accordingly, petitioners believe that there is no abuse, and that they are being penalized for a mere change in ownership of the savings and loan. However, this point is irrelevant. Congress expressly requested that the Secretary develop regulations to prevent the deduction of interest for periods in excess of the number of days or months in a short period taxable year. The regulations were specifically intended to cover change of ownership situations. Treas. Reg. § 1.461-1(e)(1)(ii) states that the section 461(e) disallowance rules will apply to a taxpayer in the year it liquidates if the liquidation follows or is a part of an asset acquisition pursuant to section 381(a). In addition, Treas. Reg. § 1.461-1(e)(3)(ii) provides that if the taxpayer is disallowed a deduction under section 461(e) solely because the taxpayer was a party to an acquisition to which section 381(a) applies, the taxpayer will be allowed to deduct the disallowed amounts pursuant to Treas. Reg. § 1.461-(e)(3)(ii).

Moreover, these regulations are consistent with the Congressional intent underlying section 461(e). (See page 10 of this memorandum for a discussion of this point.) [redacted] agreed to the change in ownership and designated the form and timing of the acquisition. The acquisition could have been structured to take place on [redacted] and section 461(e) would not have applied. Yet, [redacted] chose to structure the acquisition to occur on [redacted], invoking the application of section 461(e). Accordingly, [redacted] is bound by the tax consequences which result from the form and timing of the acquisition it chose.

C. The portions of Treas. Reg. § 1.461(e) which apply section 461(e) principles to short period taxable years are valid.

Petitioners may contend that the portions of Treas. Reg. § 1.461(e) which apply section 461(e) principles to short period taxable years are invalid. This is an argument frequently made by taxpayers when discussing the applicability of Treasury Regulations. We have concluded that the Treasury Regulations in issue are interpretative regulations and would be upheld as valid since they are consistent with the legislative history underlying section 461(e).

1. Commissioner's Authority

The portions of Treas. Reg. § 1.461-1(e) which apply section 461(e) principles to a short period taxable year are valid. Treasury Regulations command the respect of the Court, since Congress has delegated to the Secretary of the Treasury the task of "administering the tax laws of the Nation." Commissioner v. Portland Cement Co. of Utah, 450 U.S. 156, 169 (1981). United States v. Cartwright, 411 U.S. 546, 550 (1973); accord United States v. Correll, 389 U.S. 299, 307 (1967). A court should ordinarily defer to a Treasury Regulation if it "implement[s] the congressional mandate in some reasonable manner." Correll, 389 U.S. at 307 (quoted in United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982)); Portland Cement, 450 U.S. at 169; National Muffler Dealers Association v. United States, 440 U.S. 472, 476-477 (1979); Armco, Inc. v. Commissioner, 88 T.C. 946, 957 (1987). Stated another way, Treasury Regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." Portland Cement, 450 U.S. at 169; Commissioner v. South Texas Lumber Co., 330 U.S. 496, 501 (1948). When analyzing whether the regulation is inconsistent with the intent of the statute, courts focus on the legislative history underlying the statute. Armco, 88 T.C. at 958 n.7; see generally Vogel, 455 U.S. at 16; Estate of Bullard v. Commissioner, 87 T.C. 261 (1986).

2. Standards of Deference

The general deferential standard is further refined by the type of authority under which the regulations are issued. A regulation may be promulgated under the Secretary's general grant of authority under section 7805(a) to issue all necessary rules and regulations, i.e., an interpretative regulation, or it may be issued under a specific statutory grant of authority, i.e., a legislative regulation. Gehl Company v. Commissioner, 795 F.2d 1324, 1328 (1986). An interpretative regulation is to be upheld as a reasonable interpretation of the congressional intent as long as it harmonizes with the statute's language, origin, and purpose. Vogel, 455 U.S. at 26; Rowan Companies, Inc. v. United States, 452 U.S. 247, 253 (1981); National Muffler, 440 U.S. at 477. A regulation will not be inconsistent with the language of the statute "simply because the statutory language will support a contrary interpretation." Vogel, 455 U.S. at 26.

On the other hand, legislative regulations are entitled to greater deference than interpretative regulations. Vogel, 455 U.S. at 24; Rowan, 452 U.S. at 253; Armco, 88 T.C. at 957 n.7; Fife v. Commissioner, 82 T.C. 1, 15 (1984). When examining a legislative regulation, the primarily focus of the court "is whether the interpretation or method is within the delegation of authority." Rowan, 452 U.S. at 253.

The Service has taken the position that Treas. Reg. § 1.461-1(e) is interpretative. When Treas. Reg. § 1.461-1(e) was published in T.D. 6917, 1961-1 C.B. 108, the Commissioner of the Internal Revenue Service stated that this Treasury decision was "issued under the authority contained in section 7805." 1967-1 C.B. at 113. Accordingly, the Treasury Regulation will be upheld if it is a reasonable interpretation of congressional intent.

3. Congressional Intent

Although the statute does not discuss the application of section 461(e) to short period taxable years, statements in the House Committee Report show that this application of section 461(e) was expressly contemplated by Congress when enacting the statute. The House Report from the Committee on Ways and Means provides that: "It is contemplated that in any cases involving a short year, the Secretary will use his regulatory authority already available to prevent the deduction in such years for periods in excess of the appropriate number of months, or portions of months." H. Rep. No. 2544, 87th Cong., 2d Sess. 3-4 (1962). The Treasury Regulations promulgated by the Secretary to prevent the bunching of interest in a short period are consistent with the intent of Congress.

Moreover, the application of section 461(e) to disallow a portion of the interest deductions in a short period where a bunching of such deductions occurs is consistent with the legislative history of section 461(e). Congress enacted section 461(e) to prevent thrift institutions from manipulating their interest payment date in order to (accelerate or) defer interest or dividend payment deductions from one year into a subsequent year. Such a deferral could cause an appreciable tax deduction solely resulting from the timing of the deduction. H. Rep. No. 2544, supra, at 1-5.

Congress anticipated that thrift institutions could also achieve favorable tax consequences by manipulating their interest payment date to fall within a short period taxable year. A savings and loan association's deduction of interest which was credited for a period longer than the number of days or months in the short period results in the institution receiving an appreciable tax reduction resulting from the timing of the deduction. This result occurs even in those cases in which the taxpayer may not have attempted to avoid the payment of tax. Accordingly, these regulations are valid.

If you have any questions concerning the foregoing matter, please contact Jo Lynn Ricks at FTS 566-3350. This technical advice was coordinated with Branch Nos. 1 and 2, Tax Litigation Division.

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